DEC 4 2002

No. 03-547

IN THE

Supreme Court of the United States

UNITED STATES OF AMERICA,
Petitioner,

v.

JAMES G. ROBINSON AND
BARBARA L. ROBINSON,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Whether the amount of an employer's deduction under 26 U.S.C. § 83(h) for compensation paid in the form of property corresponds to the legal definition of the income received by the employee, or, instead, whether the deduction must correspond to the amount ultimately taken into income by the employee, even if that amount is legally erroneous and incorrectly values the compensation.

TABLE OF CONTENTS

Page

STATEMENT 1

ARGUMENT 7

I. THERE IS NO CONFLICT IN THE CIRCUITS THAT WARRANTS REVIEW BY THIS COURT 7

A. The Unpublished Decision in *Venture Funding* Has No Precedential Value in the Sixth Circuit 8

B. There Is No Conflict Between this Case and the Holding in *Venture Funding* 10

C. Even if There Were a Conflict, It Would Have No Practical Significance Because the Federal Circuit Is a Court of National Jurisdiction 13

II. THE DECISION OF THE COURT OF APPEALS IS CORRECT 14

A. The Court of Appeals' Decision Is Consistent with Administrative Deference Principles 15

Page

B. The Court of Appeals Correctly Held That the Employer's Deduction Should Be Measured by the Actual Value of the Transferred Stock, Not by an Understated Value Reported by an Employee 16

C. The "Safe Harbor" Regulation Provides No Reason for Refusing to Allow the Employer to Deduct the Actual Cost of Its Compensation Expense 19

III. THE DECISION BELOW DOES NOT PRESENT AN ISSUE OF RECURRING IMPORTANCE 20

CONCLUSION 23

TABLE OF AUTHORITIES

Page

CASES

Bell v. Johnson,
308 F.3d 594 (6th Cir. 2002) 9

Bowen v. American Hospital Ass'n,
476 U.S. 610 (1986) 15

Brotherhood of Locomotive Firemen & Enginemen v. Bangor & Aroostock R.R.,
389 U.S. 327 (1967) 7

Cottage Savings Ass'n v. Commissioner,
499 U.S. 554 (1991) 15

Duncan Industries, Inc. v. Commissioner,
73 T.C. 266 (1979) 21

Hamilton-Brown Shoe Co. v. Wolf Bros. & Co.,
240 U.S. 251 (1916) 7

Honigman v. Comerica Bank,
128 F.3d 945 (6th Cir. 1997) 9

Mitchell v. Chapman,
343 F.3d 811 (6th Cir. 2003) 9

National Muffler Dealers Ass'n, Inc. v. United States,
440 U.S. 472 (1979) 15

Salamalekis v. Commissioner of Social Security,
221 F.3d 828 (6th Cir. 2000) 9

Page

United States v. Cleveland Indians Baseball Co., 532 U.S. 200 (2001) 15

Venture Funding, Ltd. v. Commissioner, 110 T.C. 236 (1998), *aff'd mem.*, 198 F.3d 248 (6th Cir. 1999), *cert. denied*, 530 U.S. 1205 (2000) ..... *passim*

STATUTES

I.R.C. (26 U.S.C.) § 61 5

I.R.C. § 83(a) 1, 2, 16, 22

I.R.C. § 83(b) 2

I.R.C. § 83(d)(2) 2

I.R.C. § 83(h) 2, 6, 11

I.R.C. § 162 ..... 2, 6

I.R.C. § 422 22

I.R.C. § 423 22

I.R.C. § 1363 2

I.R.C. § 1366 2

I.R.C. § 6532 19

REGULATIONS

Treas. Reg. (26 C.F.R.) § 1.83-2(c) 3

Treas. Reg. § 1.83-2(d) 3

Page

Treas. Reg. § 1.83-6(a) (1978) 16

Treas. Reg. § 1.83-6(a)(1) 15

Treas. Reg. § 1.83-6(a)(2) 19

MISCELLANEOUS

S. Rep. No. 91-522 (1969) 13

S. Rep. No. 99-213 (1986) 18

T.D. 8599, 1995-2 C.B. 12 15

6th Cir. R. 28(g) 8

6th Cir. R. 206 9

6th Cir. R. 206(c) 9

Beth Crimmel & Jeffrey Schildkraut, *National Compensation Survey Collects Test Data on Stock Option Plans*, Compensation and Working Conditions (Bureau of Labor Statistics, Winter 1999) 22

National Association of Stock Plan Professionals and PricewaterhouseCoopers, *1998 Stock Plan Design and Administration Survey* (1999) 22

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BRIEF FOR THE RESPONDENTS IN OPPOSITION

STATEMENT

1. This case concerns section 83 of the Internal Revenue Code ("the Code" or "I.R.C."), which addresses the tax treatment of "property transferred in connection with performance of services" — in particular, property that comes with restrictions on the service provider's ownership rights. Section 83(a) provides that the transfer yields taxable income to the service provider or employee in the amount of the excess of "the fair market value of such property" over "the amount (if any) paid for such property." That amount, sometimes called the "bargain element" of the property transfer, "shall be included in the gross income" of the person performing the services. I.R.C. § 83(a).

With respect to timing, the general rule is that this bargain element of the transfer is valued and taken into income in the year that the service provider's rights in the property are no longer "subject to a substantial risk of forfeiture." *Id.* Section 83(b), however, gives the recipient an opportunity within 30 days of the transfer to elect to recognize the income in the year of receipt, notwithstanding the existence of restrictions on ownership.

Section 83(h) addresses the tax consequences to the employer of such a property transfer. It provides that the employer shall receive "a deduction under section 162" in "an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed the services."[1] Section 83(h) correlates the timing of the employer's deduction with the year in which the service provider elects to recognize the income: "Such deduction shall be allowed for the taxable year of such person . . . in which such amount is included in the gross income of the person who performed such services." I.R.C. § 83(h).

2. Plaintiffs are the sole shareholders of a group of related S-corporations in the film production business, collectively known as "Morgan Creek." Pet. App. 2a, 19a.[2] During the

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[1] Section 162 is the general Code provision that permits deduction of "trade or business expenses." Section 83(d)(2), which is not involved in this case, addresses the income tax consequences to the employee of a cancellation of an otherwise permanent restriction on the ability to transfer the property.

[2] Under the Code, the tax consequences of an S-corporation "flow through" to the shareholders, as in a partnership. The shareholders recognize the corporation's income and expenses on their individual tax returns; the corporation itself is not subject to corporate income tax. I.R.C. §§ 1363, 1366. Thus, in a tax dispute like this one involving the corporation's income or expenses, the shareholders, not the corporation, are the true parties in interest.

1989-97 period, Gary Barber was the Chief Operating Officer of Morgan Creek. *Id.* In January 1995, Morgan Creek entered into an employment agreement with Barber that transferred to him a 10% ownership interest. *Id.* Barber's full ownership of the stock vested gradually over time according to a schedule that would lead to partial forfeiture of his ownership rights in the event of early termination of his employment. *Id.* at 2a-3a, 19a n.3.[3]

Barber paid to Morgan Creek $2 million in exchange for the stock, but this payment represented only a small fraction of the stock's true value. *Id.* at 4a, 20a n.4. Plaintiffs allege that the stock at the time was worth $28.8 million. *Id.* at 5a, 20a n.4. The IRS has taken essentially the same position in auditing Barber's 1995 income tax return, valuing the stock at $28,759,800 and thus proposing in an audit report to increase Barber's income from wages for that year by $26,759,800. *Id.* at 5a, 21a.

Barber filed a timely section 83(b) election with the IRS to include the "bargain element" of the stock in his income in 1995, but he did not report any income from the stock transfer to the IRS for that year. *Id.* at 4a, 21a. Instead, he indicated that his $2 million payment reflected the fair market value of the stock and therefore the bargain element was zero. *Id.* Barber thus positioned himself to claim capital gains treatment on the gain from any subsequent sale of the stock without recognizing any ordinary income at all. *Id.* at 20a. Although the section 83 regulations require filing a copy of the section 83(b) election with the employer (*see* Treas. Reg. § 1.83-2(c), (d)), Barber did not notify anyone at Morgan Creek (other than himself) that he had filed the election. Pet. App. 5a, 20a-21a.

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[3] The reprint of the Court of Federal Claims' opinion in the appendix to the petition numbers the footnotes differently from the original, beginning the numbering with "three." In citing to the opinion, we will follow the numbering convention used in the appendix, rather than the original.

In June 1998, after a period of declining company performance, Morgan Creek and Barber decided to part ways. As part of the separation agreement, Morgan Creek repurchased from Barber the portion of his stock (80% of the total) that had vested at that time. *Id.* at 21a. The purchase price was $13.2 million, based on an estimated value for the company of $165 million. *Id.* at 5a, 21a n.5. At this time, plaintiffs learned for the first time that in 1995 Barber had made a section 83(b) election to take the bargain element of his stock purchase into income in that year. *Id.* at 5a, 21a. As a result, Morgan Creek promptly calculated the 1995 value of the property transferred and, in August 1998, issued corrected Forms W-2 for 1995 increasing Barber's wage income for that year by more than $20 million. *Id.*

3. In 1999, plaintiffs filed an administrative claim for refund of their 1995 taxes. Plaintiffs asserted that, in light of Barber's section 83(b) election, Morgan Creek was entitled under section 83(h) to deduct in 1995 the bargain element of the stock transfer as a business expense of compensating its corporate officer. After the IRS failed to act on the refund claim, plaintiffs brought this suit seeking a refund for 1995 of $8,854,281, plus interest, based on a valuation of Barber's stock at $28.8 million. *Id.* at 6a, 21a-22a.

The trial court dismissed the complaint, rejecting plaintiffs' position that the court should determine the amount of their business expense deduction by determining the value of the transferred property, in accordance with the legal definition of the income required to be recognized by Barber. *Id.* at 18a-31a. The court ruled that plaintiffs' refund claim was "unripe" on the ground that "plaintiffs' entitlement to a deduction for 1995 depends upon a final determination of the amount included in Mr. Barber's income." *Id.* at 30a. Thus, the court ruled that the employer has no right to an independent determination of the amount of its expense; the amount of its deduction is conclusively governed by the employee's tax treatment — without regard

to whether that tax treatment accurately reflects the value of the compensation paid.

The trial court grounded its conclusion entirely upon the "plain and unambiguous meaning" of the statute. *Id.* at 24a. The court explicitly acknowledged that its conclusion deviated from the legislative history, which described the allowable deduction as "the amount which the employee is required to recognize as income." *See id.* at 24a n.7 (quoting S. Rep. No. 91-552, at 123 (1969)). The trial court concluded, however, that regardless of the Congressional intent expressed in the legislative history, the court "must apply the plain, unambiguous meaning of the statute." *Id.* Similarly, the trial court found that it was powerless to accommodate "plaintiffs' reasonable concerns" (*id.* at 29a) about the adverse policy implications of its ruling — notably, that it puts the employer's deduction at the mercy of the outcome of a dispute between two other parties, who may lack an incentive to have that outcome reflect the true value of the property. The court stated that, although it "appreciates the vulnerability of plaintiffs to the outcome of Mr. Barber's administrative appeals, the court cannot avoid the unambiguous language of I.R.C. § 83(h) on this basis." *Id.* at 28a.

4. The court of appeals reversed and remanded the case for a determination of the value of the transferred stock. *Id.* at 1a-17a. The court first focused on the statutory language and its context in the Internal Revenue Code. It observed that the "statutory context in which the term 'included' is used" supports plaintiffs' position because the key definition of gross income in I.R.C. § 61 "plainly refers to items that are included in gross income as a matter of law or legally deemed to be included in gross income." *Id.* at 8a & 9a. The court added that "other statutory provisions in the same portion of the Code also use the term 'included' to mean 'included as a matter of law.'" *Id.* at 9a. The court also observed that the trial court's decision is inconsistent with Congress's explicit identification of the section 83(h)

deduction as an ordinary and necessary business deduction under Code section 162. *Id.* at 10a-11a. The Court explained: "There is no logical reason for the amount of the deduction under the parallel provision of section 83(h) to be based on the reporting activity of the employee, rather than the fair market value of the transferred property, simply because the employee's rights in the transferred property may not vest immediately." *Id.* at 11a.

In addition to the plain language of the statute, the court of appeals pointed to other reasons why the trial court's decision is untenable. The court noted that "the government's interpretation of section 83(h) is contrary to the legislative history and contemporaneous interpretation of section 83." *Id.* The court also emphasized that the original Treasury regulations, which were on the books for 17 years, explicitly defined the term "included" in accordance with plaintiffs' position and "thus make clear that until relatively recently the IRS understood the term 'included,' as used in section 83(h), to mean 'includible.'" *Id.* at 13a. The court concluded that the statutory language and the other corroborative evidence could not be overcome by the government's reliance on contrary language in the preamble to a 1995 revision of the relevant regulation. *Id.* at 14a-15a. Finally, the court of appeals also pointed to the unfairness to the employer that is inherent in the trial court's ruling, noting that "the employer would be helpless to avoid a settlement between the IRS and the employee that significantly understated [the property's] value, and thus resulted in an artificially low deduction for the employer." *Id.* at 15a-16a.

The court of appeals accordingly reversed and remanded "for a determination of the value of the Morgan Creek stock that was transferred to Mr. Barber." *Id.* at 16a. The court noted that its decision "conflicts with language in" the Tax Court's 9-8 decision in *Venture Funding, Ltd. v. Commissioner*, 110 T.C. 236 (1998), *aff'd mem.*, 198 F.3d 248 (6th Cir. 1999), *cert. denied*, 530 U.S. 1205 (2000), but

that it found the contrary arguments to be persuasive. Pet. App. 16a-17a.

ARGUMENT

The government advances three reasons why this Court should grant certiorari: (1) the need to resolve an alleged conflict in the circuits; (2) the need to correct an erroneous court of appeals decision; and (3) the need to resolve a question of "substantial recurring importance." Pet. 9-10. Each of these assertions is unfounded.

First, there is no conflict in the circuits. The allegedly conflicting case is an unpublished decision that has no precedential value and that, in any event, addresses a different issue. Second, the court of appeals' decision is correct for the reasons well stated in the court's comprehensive opinion, to which the government provides little response in its petition. Third, the government supports its claim of substantial administrative importance by reference to situations that are not affected by the decision below. In fact, that decision addresses an unusual fact situation and a statute that has produced little litigation in the more than 35 years of its existence.

Thus, even if the Court were inclined to deviate from its usual practice of awaiting the completion of proceedings in the trial court, rather than reviewing an interlocutory decision of the court of appeals (*see Brotherhood of Locomotive Firemen & Enginemen v. Bangor & Aroostock R.R.*, 389 U.S. 327, 328 (1967); *Hamilton-Brown Shoe Co. v. Wolf Bros. & Co.*, 240 U.S. 251, 258 (1916)), there is no reason for further review here.

I. THERE IS NO CONFLICT IN THE CIRCUITS THAT WARRANTS REVIEW BY THIS COURT

The primary ground advanced by the government for certiorari is a "particularly compelling" need to resolve an alleged circuit conflict with *Venture Funding, Ltd. v. Commissioner*, 198 F.3d 248 (6th Cir. 1999) (Table), *aff'g* 110 T.C. 236 (1998), *cert. denied*, 530 U.S. 1205 (2000).

Pet. 9. This claim is insubstantial for three distinct reasons. First, *Venture Funding* is an unpublished opinion that, under the Sixth Circuit's rules, has no precedential value. Thus, there is no basis for the contention that the Federal Circuit's decision "precludes uniform national enforcement" of the tax laws. Pet. 9. Second, *Venture Funding* involved a different issue from this case. Whatever "conflict" exists between the two is limited to certain "language in the decision of the Tax Court" (Pet. App. 16a); there is no conflict between the holdings. Third, even if there were a conflict between the two cases, that would be of no significance because the Federal Circuit is a court of nationwide jurisdiction. There is no reason to expect any taxpayer in plaintiffs' position to choose to file its case outside the Federal Circuit and thus voluntarily give up its day in court.

A. The Unpublished Decision in *Venture Funding* Has No Precedential Value in the Sixth Circuit

The government's allegation of a circuit conflict warranting Supreme Court review rests on the premise that *Venture Funding* is binding precedent in the Sixth Circuit. The government supports this premise with a partial quotation of Sixth Circuit Rule 28(g) that supposedly suggests that "unpublished decisions of that circuit may be cited as 'precedential'" in certain circumstances. Pet. 9 n.3. In fact, the cited rule states that the citation of unpublished decisions is "disfavored," and, although it permits citation in certain circumstances, it certainly does not state that the Sixth Circuit views them as "precedential."[4]

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[4] Sixth Circuit Rule 28(g) provides as follows: "Citation of unpublished decisions in briefs and oral arguments in this Court and in the district courts within this Circuit is disfavored, except for the purpose of establishing res judicata, estoppel, or the law of the case. If a party believes, nevertheless, that an unpublished disposition has precedential value in relation to a material issue in a case, and that there is no published opinion that would serve as well, such decision may be cited if that party serves a copy thereof

The law of the Sixth Circuit is clear that such decisions are not binding precedent. The Sixth Circuit addresses the significance of publication of decision in its Rule 206, which establishes criteria and procedures for publication. Rule 206(c) provides as follows (emphasis added): "***Published* Decision Binding**. *Reported* panel opinions are binding on subsequent panels. Thus, no subsequent panel overrules a *published* opinion of a previous panel. Court en banc consideration is required to overrule a *published* opinion of the court."

The obvious implication of this rule is that unpublished opinions are *not* binding on subsequent panels, and the Sixth Circuit has repeatedly stated and applied that principle in its decisions. *See, e.g., Mitchell v. Chapman*, 343 F.3d 811, 832 n.27 (6th Cir. 2003) ("As an unpublished opinion, the decision is not binding precedent."); *Bell v. Johnson*, 308 F.3d 594, 612 n.7 (6th Cir. 2002) (cited case "was unpublished and therefore is not binding on this panel"); *Salamalekis v. Commissioner of Social Security*, 221 F.3d 828, 833 (6th Cir. 2000) (cited case "is not binding precedent because the opinion is unpublished"); *Honigman v. Comerica Bank*, 128 F.3d 945, 948 (6th Cir. 1997) (cited decision is "unpublished, and thus not binding on this court"). Accordingly, the Sixth Circuit's brief, unpublished affirmance in *Venture Funding* has no binding effect in future litigation, and its existence creates no legitimate concern that the Federal Circuit's decision in this case could lead to disparate results for similarly situated taxpayers in the future.

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on all other parties in the case and on this Court. Such service shall be accomplished by including a copy of the decision in an addendum to the brief."

B. There Is No Conflict Between this Case and the Holding in *Venture Funding*

Even if the Sixth Circuit's unpublished affirmance in *Venture Funding* were precedential, it still would not establish a conflict in the circuits. That case involved a different issue, and different statutory language, from the instant case. The issue in *Venture Funding* concerned the timing of the section 83(h) deduction and whether the taxpayer was permitted to take the deduction at all. There was no dispute over the amount. *See* 110 T.C. at 266 (Ruwe, J., dissenting) ("There is also no question in this case regarding the amount of any potential deduction pursuant to the formula in the statute.") Here, by contrast, there is no dispute that plaintiffs are entitled to a section 83(h) deduction in the year in which Barber elected to report the stock transfer; the only issue is the amount of that deduction. That is why the Federal Circuit stated no more than that its decision "conflicts *with language*" in *Venture Funding*. Pet. App. 16a (emphasis added). The holdings and results of the two cases are not in conflict. Thus, in the unlikely event that a case identical to this one were to arise in the future, even the Tax Court would be free to adhere to its *Venture Funding* holding and still resolve the issue presented in this case the same way the Federal Circuit did.

In *Venture Funding*, the employer issued stock as compensation to twelve employees in 1988. Both the employer and the employees, most of whom were also shareholders, kept the IRS in the dark. Although the stock was unrestricted and therefore its transfer certainly triggered income in 1988, the employer did not issue Forms W-2 reflecting the compensation, and none of the employees reported the transfer as income to the IRS. The employer eventually claimed a deduction exceeding $1 million on its 1988 tax return for the value of the transferred property. It appears, however, that by this time the IRS was unable to collect any income tax from the employees, presumably because the statute of limitations had expired before the IRS

learned of the transaction. *See* 110 T.C. at 256 (opinion of Beghe, J.). Thus, if the employer had been permitted to take a deduction, the IRS would have had no opportunity to avoid suffering a net loss — directly traceable to the concealment of the transaction by the employer and employees.

That situation contrasts sharply with this case where the employer filed corrected Forms W-2 to notify the IRS of the true value of the transferred stock as soon as plaintiffs learned of the employee's section 83(b) election, thereby giving the IRS the opportunity to protect its interests with respect to both parties to the transaction. The misconduct here was committed by the employee, who grossly underreported his income to the IRS and failed to notify his employer of the section 83(b) election that would make the stock transfer fully deductible and includible in income in that year. Yet the government argues that the proper outcome is to punish *the employer* by denying plaintiffs the opportunity to prove the value of the transferred stock and forcing them to take a deduction based on the employee's reporting — one that likely will fall short of the actual amount of their compensation expense.

The legal issue in *Venture Funding* was whether the employer was entitled to any deduction at all. The key statutory inquiry was the meaning of the timing provision, the last sentence of section 83(h), which specifies that the employer's deduction is allowed for the same taxable year in which the amount is included in the employee's gross income. Because the stock value was never going to be taken into income by the employee, the government argued that the employer could not take any deduction, and a sharply divided Tax Court agreed. Here, by contrast, all agree that plaintiffs are entitled to a section 83(h) deduction for the 1995 tax year, in which Barber reported the transaction and for which the employer filed corrected Forms W-2. The only dispute here is over the amount of that deduction, with plaintiffs arguing that the deduction is measured by the true value of the stock and the government

arguing that it must be measured by whatever amount Barber ends up taking into income.

Thus, the conclusion of the Tax Court majority in *Venture Funding* was that the taxpayer "has not met the requirements for deductibility under section 83(h), and it has not met the requirements for deductibility under section 1.83-6, Income Tax Regs., either pre- or post-amendment." 110 T.C. at 248. Here, the government acknowledges that plaintiffs are entitled to a deduction after Barber's dispute is resolved; the only dispute concerns the amount of that deduction. Moreover, the Tax Court's approach to other interpretive evidence further highlights the difference in the issues presented in the two cases. As quoted above, the Tax Court in *Venture Funding* found that the government's position was supported by the "pre-amendment" 1978 version of the regulations, whereas here those regulations are directly contrary to the government's construction of the statute. *See* Pet. App. 13a; *infra* p. 17. Similarly, here the government disparages resort to the legislative history, which is directly contrary to its position, but in *Venture Funding* the Tax Court found that its position was consistent with the "legislative intent for section 83." *Compare* Pet. 19-20 with 110 T.C. at 241. In short, there is no genuine conflict between this case and the Tax Court's decision in *Venture Funding* that was affirmed by the Sixth Circuit in a brief, unpublished decision.[5]

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[5] The government errs in suggesting that it is nonsensical for the employee's reporting actions to control the timing of the employer's deduction while the amount of the deduction is determined independent of the employee's return position. *See* Pet. 20-21. There is no reason why the amount of the deduction should depend on the employee's reporting; the actual compensation expense is an objectively determinable number derived from the true value of the transferred property at the time it is taken into income. Conversely, the timing of the deduction cannot be determined without reference to the employee's actions because the employee can elect when to take the compensation

C. Even if There Were a Conflict, It Would Have No Practical Significance Because the Federal Circuit Is a Court of National Jurisdiction

The government states that the alleged conflict is "particularly compelling" because "[a]ll cases within the deficiency jurisdiction of the Tax Court . . . will be decided under one understanding of the statute, while all cases within the refund jurisdiction of the Court of Federal Claims will be decided under a conflicting interpretation." Pet. 9. But in contrast to the regional circuits, no taxpayer is forced into either of these two jurisdictions. Any taxpayer can choose to litigate in the Tax Court or, alternatively, to file a refund suit in the Court of Federal Claims that will be reviewed by the Federal Circuit. Thus, even if the Tax Court or the Sixth Circuit had established a rule that conflicts with the decision below, there is no reason to think that a case involving the same issue would arise in those jurisdictions in the future. *See*, *e.g.*, Petition for Certiorari, at 11, *United States v. Weyerhaeuser Co.*, No. 96-714 (Nov. 1996) ("Because the Federal Circuit has a nationwide jurisdiction, and because all taxpayers are entitled to pay the tax and sue for a refund in the Federal Circuit, it is unlikely that other courts of appeals will have an opportunity in the future to review this same issue.").

The government seeks to avoid this problem by raising the possibility of "taxpayers who lack the ability to pay taxes as they are assessed" and who therefore will choose to litigate

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into income and the employer must take its deduction in the same year. *See* Pet. 19 (quoting S. Rep. No. 91-522, at 123 (1969)). Indeed, even the *Venture Funding* court recognized that the government's suggestion mistakenly ignores the key differences between the respective inquiries into the amount and timing of the deduction. *See* 110 T.C. at 251 (Colvin, J., concurring) ("The same word or phrase appearing in different places in the internal revenue laws may have different meanings depending on the context and legislative purpose involved.").

in the Tax Court. Pet. 10. But while this observation might have force in some cases, it ignores the nature of the issue here. The government's position is that the employer has no right to litigate the amount of its own deduction; the employer *must* deduct the amount taken into income by the employee without having its own day in court. Thus, the Tax Court offers no refuge for an employer who cannot pay the assessed taxes. If an employer were to eschew a refund suit and instead file a petition in the Tax Court, the government would seek to have the case dismissed, as it did in the trial court here. There would be *nothing to litigate* in the Tax Court, and the employer would have to pay the assessed taxes anyway. Thus, if it is true that the Tax Court's position is contrary to that of the Federal Circuit, the employer has no way to avoid paying the assessed taxes up front, and its only option for contesting those taxes is a refund suit.

In sum, contrary to the government's assertions, the decision in this case neither "precludes uniform national enforcement" of the tax law nor poses any risk of "inconsistent treatment of taxpayers." *See* Pet. 9, 24.

II. THE DECISION OF THE COURT OF APPEALS IS CORRECT

The court of appeals cogently explained that its decision is supported by the plain language of the statute, by the way that the relevant language is used elsewhere in the Internal Revenue Code, by the legislative history and contemporaneous construction of the statute, including the original regulation promulgated by the Treasury Department, and by the policy considerations of allowing the employer its day in court when threatened with the imposition of an artificially low deduction. The government provides little response to most of these points, but it argues that the court of appeals' decision cannot stand because of the 1995 amendments to the regulations. Pet. 12, 14-18, 21. This contention is without merit.

A. The Court of Appeals' Decision Is Consistent with Administrative Deference Principles

The springboard for the government's argument is the following assertion: "The applicable Treasury regulations explain that, as used in Section 83(h), 'the amount included means the amount reported on an original or amended return or included in gross income as a result of an IRS audit of the [employee].'" Pet. 12 (quoting T.D. 8599, 1995-2 C.B. 12, 13). *See also* Pet. 17 ("the agency's regulations thus unambiguously define the word 'included'" in accordance with the above quotation). In fact, the regulations themselves say no such thing. The quotation is from the preamble to the final regulations. The regulation itself, Treas. Reg. § 1.83-6(a)(1), is set forth at Pet. App. 35a, and its text merely describes the amount of the employer's deduction in language almost identical to that of the statute itself.

Thus, there is no question here of *Chevron* deference to the regulation itself. The government, however, cites (Pet. 17) to *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 218-19 (2001), which recognizes a principle of deference to agency interpretations of its own regulations. But that case emphasizes that an important element of the inquiry into the appropriate level of deference is whether the agency interpretation is contemporaneous and longstanding. *See id.* at 219-20 (according deference to "steady interpretation of [Treasury's] 61-year-old regulation"); *see also Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 561 (1991) (adhering to "Treasury regulations and interpretations long continued without substantial change"); *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 477 (1979) (deferring to "substantially contemporaneous construction"); *Bowen v. American Hospital Ass'n*, 476 U.S. 610, 646 n.34 (1986) ("The fact that the agency's interpretation 'has been neither consistent nor longstanding . . . substantially diminishes the deference to be given . . . .'") (citation omitted).

The interpretation relied upon by the government here is neither contemporaneous nor consistently held. To the contrary, the contemporaneous administrative interpretation of section 83(h) in the original regulation unequivocally states the rule adopted by the court of appeals; that regulation defined the employer's deduction as "'equal to the amount *includible* as compensation in the gross income of the service provider, under section 83(a), (b), or (d)(2).'" Pet. App. 13a (quoting Treas. Reg. § 1.83-6(a) (1978)). Thus, the government's current position carries with it the dubious implication that the regulations in force from 1978 to 1995 were invalid. In sum, even apart from the conflict between the language in the preamble and the plain language of the statute (*see* Pet. App. 15a), administrative deference principles provide no support for the government's position.

B. The Court of Appeals Correctly Held That the Employer's Deduction Should Be Measured by the Actual Value of the Transferred Stock, Not by an Understated Value Reported by an Employee

The government's "Question Presented" misstates the holding of the court of appeals. The court held only that an employer is entitled to take a deduction for the expense of the compensation it pays in the form of property, which is measured by the "fair market value of such property," as prescribed in the statute. I.R.C. § 83(a). If there is a dispute over that fair market value, the employer is entitled to a judicial resolution of the dispute and to defend its position before the court, as with any other tax dispute.

Thus, it is simply not true that the court of appeals held that the employer may deduct an "amount that . . . the employer claims *should* have been 'included' in the employee's income." Pet. I. What the employer "claims" is irrelevant. The deduction is based on the court's determination of the fair market value of the compensation — in an adversary proceeding in which the government can present its case.

Ironically, the government's mischaracterization of the court's holding actually represents the mirror image of the government's own unfair position. Under the government's interpretation, the employer may be bound by the amount "claimed" or reported by the employee on his return, even if that amount is wildly understated. If the IRS accepts the employee's report of his income or, as commonly occurs, fails to audit the return, then the employer would be forced to take "an artificially low deduction" in the amount reported by the employee. *See* Pet. App. 16a. Indeed, the government suggests at one point that the amount "claimed" by the employee may be controlling even in this case where the IRS is auditing the employee's return. The petition indicates that plaintiffs are entitled to no deduction because Barber "'included' *no* 'bargain element' in his income," and "[s]ince the plain text of the statute allows only 'such amount' — the amount 'included' as income by the employee — to be claimed as a deduction by the employer, the statute expressly precludes the employer's present claim for a deduction in this case." Pet. 11-12.

Similarly, there is no basis for the government's accusation that the plaintiffs seek to take "an inflated deduction." Pet. 12. There is nothing "inflated" about a deduction that accurately reflects an employer's compensation expense. Indeed, the supposedly "inflated" value that plaintiffs have placed on the stock is the same value that the government itself has placed on the stock in its audit report of Barber, and that value is supported by contemporaneous independent valuations of the company. *See* Pet. App. 5a, 21a; C.A. App. 264-65, 282, 481. The problem here is the potentially "deflated deduction" that the government seeks to impose upon the plaintiffs without giving them the opportunity to dispute the value that the government might agree upon with the employee in a separate proceeding.

The government argues that its position is justified by the possibility that the respective decisionmakers in this case and

in Barber's case would not find the "identical" value for the stock. Pet. 14 n.5. If the value is higher in the employer's case, then the government would be "whipsawed" and could not collect the full tax that it is owed. *See* Pet. App. 15a-16a. That possibility, however, is common to many situations in the tax law that involve valuation, and there is no reason to think that it would have induced Congress to create the unique rule in section 83 for which the government contends. For example, section 1060 of the Code was enacted to address a whipsaw problem that Congress had specifically identified in the area of asset allocation, yet Congress did not respond by forcing one party to the transaction to accept the other party's valuation. Congress acted to "*diminish* some of this 'whipsaw' potential" by requiring uniform use of a particular valuation method, but it saw no need to *eliminate* any possibility of whipsaw by taking away a party's right to its own day in court. S. Rep. No. 99-213, at 254 (1986) (emphasis added). Similarly here, section 83(h) protects the government by requiring that the employer and the employee both use the same "method" — that is, recognizing and valuing the amount of compensation in the same year — but it does not take away the employer's right to an individual determination.

As the court of appeals found, much stronger policy considerations than "whipsaw" militate against the government's position. The government would force the employer to use the value determined in the employee's separate tax dispute with the IRS, which places the employer in an untenable position. During administrative consideration of a multi-issue dispute, the IRS would have every incentive to capitulate to the employee's claim of a relatively low property valuation in exchange for the employee's concession on another issue. The IRS would reap the fruits of a victory on the second issue and then could effectively recoup its losses on the section 83 issue from the employer, who would be saddled with an artificially low deduction. Moreover, even if one assumes that the

employee's dispute would ultimately culminate in an accurate valuation, the employer still is harmed by having resolution of its own tax liability for a particular year held hostage indefinitely pending resolution of the employee's dispute — a dispute that neither the government nor the employee has any incentive to expedite. There simply is no reason to believe that Congress intended in section 83(h) to create a system so fraught with unfairness and practical problems.[6]

C. The "Safe Harbor" Regulation Provides No Reason for Refusing to Allow the Employer to Deduct the Actual Cost of Its Compensation Expense

The government also argues that plaintiffs should not prevail because the "elective safe-harbor provided by the regulations was not followed by the employer in this case." Pet. 12. This statement refers to the regulatory provision that states that, if the employer timely files a Form W-2, the employee will be "deemed to have included the amount" listed on the Form W-2 in his income. Treas. Reg. § 1.83-6 (a)(2). The plaintiffs, of course, did file corrected Forms W-2 listing income for Barber in the same amount for which plaintiffs claim a deduction; those forms were filed late, however, because Barber was the only person at Morgan Creek with timely knowledge of his section 83(b) election and he was the Chief Operating Officer responsible for filing the forms. In fact, the plaintiffs argued in the alternative

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[6] Indeed, if Congress had intended that the employer would have no right to claim a deduction until after resolution of the employee's tax dispute, presumably Congress would have made some adjustment to the statute of limitations rules to preserve the employer's access to the courts. As it stands, a taxpayer must file a refund suit within two years of the denial of an administrative claim for refund. I.R.C. § 6532. Thus, if and when Barber's tax dispute is finally resolved, plaintiffs will be time-barred from filing suit to claim a deduction based on that resolution.

that, under the circumstances here where Morgan Creek filed corrected Forms W-2 as soon as practicable after plaintiffs learned of Barber's election, the regulatory "safe harbor" was satisfied. The court of appeals did not reach that issue. *See* Pet. App. 16a.

In any event, assuming that the plaintiffs failed to satisfy the safe harbor regulation, that is no reason why they should be denied a deduction that corresponds to the true value of the stock. The safe harbor is designed to enable the employer to protect itself against the possibility that the employee would not report the transaction to the IRS, which would disqualify the employer from getting any deduction under *Venture Funding*. The regulation is not designed to affect the amount of the deduction, and the statute does not make withholding a precondition to the employer's section 83(h) deduction.

We note that the terms of the safe harbor regulation confirm the correctness of the court of appeals' decision. It is undisputed that an employer who satisfies the "safe harbor" is entitled to a deduction in the amount set forth on the Form W-2 if that reflects the actual value of the stock — even if the employee reports a smaller amount as his income. If the government were correct that section 83(h) limits the employer's deduction to the amount taken into income by the employee, then that regulation would be allowing a deduction that is not authorized by the statute.

III. THE DECISION BELOW DOES NOT PRESENT AN ISSUE OF RECURRING IMPORTANCE

The government claims that this decision implicates "a recurring issue of substantial importance both to the public and to the public fisc." Pet. 24. The petition makes two assertions in this regard: (1) many companies previously issued stock options to their employees, and they will now be allowed to obtain deductions where the employees did not report income; and (2) the court of appeals' decision somehow "invites collusion between employers and

employees and provides unscrupulous taxpayers with a method for understating and evading their tax obligations." Pet. 23. These assertions are unfounded.

The decision below simply allows an employer to take a deduction for the actual cost of its compensation expense, in a case where the IRS is fully able to protect its interests by litigating against the employer and by proceeding against the employee. Thus, although the government's concern about the consequences of deception by the employer may be analogous to the situation in *Venture Funding*, it has little to do with this case. In any event, if "unscrupulous taxpayers" try to defraud the government through deceptive reporting of compensation, the law provides the government with more targeted weapons to combat such fraud than a blanket rule that would deny a legitimate deduction to the law-abiding majority of employers.

We note that, prior to 1995, the government's own regulations, as well as the Tax Court, took the same view as the court of appeals below that the amount of the employer's deduction is the amount that the employee is legally required to include in his income. *See supra* p. 17; Pet. App. 13a; *Duncan Industries, Inc. v. Commissioner*, 73 T.C. 266, 285 (1979) (employer can deduct under section 83(h) "an amount equal to the amount *includable* in the service performer's income under section 83(a)" (emphasis added)). Yet *Venture Funding* appears to be the only reported case in the 35 years of section 83(h) in which the government has been faced with the prospect of allowing an employer's deduction without being able to tax the employee. In addition, most of the "cash-strapped technology start-ups" to which the government refers (Pet. 22) had little use for a section 83(h) deduction because they had no taxable income. Hence, they are unlikely candidates to file refund suits. Accordingly, the alleged risk of refunds being "belatedly allowed" (Pet. 23) to companies who previously granted stock options (for most of whom the statute of limitations has long expired) hardly seems significant enough to warrant certiorari.

Moreover, some common kinds of stock options are not governed by section 83(a). Incentive stock options are governed by I.R.C. § 422; employee stock purchase plans are governed by I.R.C. § 423. Unless the employee fails to meet a specified employment requirement or disposes of the stock prior to expiration of the required holding period, these kinds of options do not give rise to any deduction by the employer. Recent surveys show that incentive stock options are used by almost half of the employers who use stock options as compensation. *See* Beth Crimmel and Jeffrey Schildkraut, *National Compensation Survey Collects Test Data on Stock Option Plans*, Compensation and Working Conditions, at 19 (Bureau of Labor Statistics, Winter 1999) (44%); National Association of Stock Plan Professionals and PricewaterhouseCoopers, *1998 Stock Plan Design and Administration Survey*, at 11 (1999) (47.3%).

Thus, the government appears to have greatly overstated the threat that the decision below poses to the public fisc. Its primary effect will be to ensure that employers have the right to their day in court to argue for a deduction for the actual cost of their compensation expense, as contemplated by Congress, while still allowing the government to collect the tax to which it is entitled.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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